

**Remarks of  
Commissioner Linda K. Breathitt  
Federal Energy Regulatory Commission**

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Thank you for inviting me to speak with you today. I appreciate this opportunity to discuss some of the important challenges confronting the electric industry and the Commission. I believe the title of this Forum—"Forging the Future"—is appropriate because that is exactly what we are doing. Just as the metalsmith at his forge meticulously shapes metal by heating and then hammering it, we are reshaping the electric industry to meet the demands of a new competitive marketplace with vigor, however the hammer part is in the eye of the beholder. Some think it is used all too frequently while others think we left it in our old building, never to be seen again.

For several years now the Commission's "forging" activities have been focused on the transmission sector of the electric industry. With careful and deliberate actions the Commission has sought to address the changing needs and nature of the industry. These actions have included, among other things, a transmission pricing policy statement, open access transmission rules in Orders No. 888 and 889, and most recently our Notice of Proposed Rulemaking on Regional Transmission Organizations.

My remarks today will focus primarily on this last item—the Commission's RTO NOPR—and in particular on how our developing transmission policies will enable the Commission to ensure, for the burgeoning competitive electric marketplace, an adequate supply of transmission capacity well into the future. This is an issue that I've been keenly interested in since coming to the Commission two years ago, and I know it is one that you, as industry leaders, are also interested in. Ensuring an adequate supply of transmission capacity for the Nation will be an incredible challenge, but one that the Commission and the industry must meet head on. It is clear to me that the success of the

Commission's goals of transmission open access and wholesale competition depend on an adequate and reliable supply of transmission capacity. So how do we go about filling this tall order?

As I see it, the Commission will have to meet this challenge on numerous fronts. But today, I'll focus on three areas that I believe will require special attention by the Commission. First, we will have to develop and implement effective regional congestion management procedures. Second, we will have to reform our transmission pricing policies and encourage innovative pricing proposals by the industry. And third, we will have to encourage necessary transmission grid expansion and enhancement.

The issues of transmission congestion, pricing and expansion are not major elements of the NOPR. Combined, the discussion of these topics probably takes up less than 20 of the more than 200 pages of the NOPR. However, in my opinion, they are important issues to which the Commission and the industry must devote a significant amount of time in the near future. I fully expect that issues related to transmission adequacy, such as congestion management, transmission pricing, and system expansion, will be among the most vexing and complicated issues the Commission will contend with during the next several years.

Since the issuance of Order No. 888 in 1996, there has been a tremendous increase in the amount of wholesale electric power being traded. Open access and industry restructuring, both at the wholesale and retail levels, have caused demand for transmission capacity to soar. And the Nation's transmission grid is struggling to keep pace with the industry's rapid growth.

As our RTO NOPR points out, since 1995, sales by one sector in particular—power marketers—have risen exponentially. In the first quarter of 1995, according to power marketer quarterly filings at the Commission, marketer sales totaled approximately 2 million megawatt-hours. By the second quarter of 1998, sales by power

marketers sky-rocketed to over 500 million megawatt-hours. That is a phenomenal 25,000 percent increase in just three and a half years! Over this same period, many new competitors have entered the industry. In the first quarter of 1995, there were 8 power marketers actively trading in wholesale power markets. By the middle of 1998, there were 108 actively trading marketers.

These figures suggest that the Commission's goal of increasing competition in the wholesale power market is working. But, because of these changes, the transmission grid is now being used more intensively and in different ways than in the past. This increased usage is imposing tremendous strain on the system.

The transmission system that exists in the United States today was never intended to be an efficient and coordinated nation-wide grid. It was built over many decades by individual, vertically-integrated electric utilities for the sole purpose of serving the needs of their specific customers. Later, in order to make their transmission systems more secure and reliable, the utilities established a limited number of interconnections with neighboring utilities. These interconnections were not built for the purpose of engaging in wide-spread commerce of electricity, but rather for sharing economic and emergency power among non-competing utility systems, usually during periods of contingencies. The grid certainly was not built to accommodate the traffic it is presently experiencing.

The current strain on the transmission system is a concern not only of the Commission, but also of the North American Electric Reliability Council (NERC). In its reliability assessment report last September, NERC stated that, "the adequacy of the bulk transmission system has been challenged to support the movement of power in unprecedented amounts and in unexpected directions." NERC goes on to say that these changes in the use of the transmission system "will test the electric industry's ability to maintain system security in operating the transmission system under conditions for which it was not planned or designed."

NERC's report also points out that planning and construction of transmission and transmission-related facilities is not keeping up with increased requirements. According to NERC, "very little is being done to increase the load serving and transfer capability of the bulk transmission system." It is apparent that transmission-owning utilities are wary of making transmission-related investments given the uncertainties they face in a restructured industry and the risk of earning inadequate returns on new transmission investments - not to mention the difficulties of siting them.

I believe there are some things FERC can do to ensure that these circumstances improve. Let me turn now to the three areas I've already identified where the Commission must concentrate its efforts: (1) adopt efficient regional congestion management mechanisms and procedures; (2) ensure that our transmission pricing policies conform to the changing electricity marketplace, and that transmission owners and operators are encouraged to file innovative pricing proposals; and (3) provide proper incentives to market participants to invest in new transmission facilities.

### **Congestion Management**

I've already mentioned that transmission congestion has become an important problem for the electric industry. Several examples bear this out. Transmission constraints were cited as one of the key factors contributing to the Midwest price spikes in June 1998. It was found that transmission constraints reduced the ability of utilities to move power where it was needed. Earlier this year, the Department of Energy initiated an investigation into "major power outages" resulting from insufficient generation or transmission problems. Secretary Richardson stated at that time that he would also convene a regional summit of governors, state public utility commissioners, and other state officials in the Northeast to discuss new transmission lines that can ease supply problems in that region. In addition, our RTO NOPR cited a lack of regional congestion management systems and planning for expansion as an impediment to a competitive wholesale electric market.

In an order issued earlier this year on NERC's transmission loading relief procedures, the Commission stated that traditional approaches to congestion management may no longer be acceptable in a competitive industry. We contended that the use of administrative curtailment procedures, such as TLR, are usually invoked without regard to the relative value of transactions that are curtailed. In the RTO NOPR, the Commission concluded that efficient congestion management requires a greater reliance on market mechanisms.

We further stated that only a regional organization like an RTO will be able to create a workable and effective congestion management market. I believe a major benefit of RTOs is that they allow the grid to be managed more efficiently by facilitating regional transmission pricing and congestion management, providing better estimates of available transmission capacity, and planning efficiently for transmission and generation investments needed to increase transmission capacity.

In our order approving the PJM ISO in November 1997, we stated that markets that are based on locational marginal pricing and financial rights for firm transmission service provide a sound framework for efficient congestion management. However, in the RTO NOPR we make clear that we are not requiring one specific market approach to congestion management. Rather, we indicated that RTOs should have considerable flexibility in experimenting with different market approaches to managing congestion. Nonetheless, we stated that a workable market approach to congestion management should: establish clear and tradable rights for usage; promote efficient regional dispatch; support the emergence of secondary markets for transmission rights; and provide market participants with the opportunity to hedge locational differences in energy prices.

The Commission believes that a market approach to congestion management should lead to more efficient transmission prices. In order to encourage the development of congestion management plans by RTOs, our NOPR proposes that RTOs should implement regional congestion management plans one year after commencement of

operations. I support the development of regional, market-based congestion management plans and believe that many of our congestion-related problems can be alleviated in that manner.

### **Transmission Pricing Reform**

This leads to my second topic—transmission pricing reform. I believe the Commission must ensure that its pricing policies and practices are compatible with the changing nature of the electric industry. Appropriate transmission pricing mechanisms should encourage the most efficient use of existing facilities and provide proper incentives to investors and market participants to expand and enhance the Nation's grid.

Reforming the way in which transmission services are priced will not be simple. However, I believe that the development of transmission pricing mechanisms that include proper incentives and send the right price signals to market participants will ensure that the Commission's goal of a fully competitive wholesale electric market will be achieved.

Since coming to the Commission, I've been told by industry representatives and others that the Commission's current transmission pricing policies are in need of reform and are sending the wrong price signals to transmission owners and users. Through these conversations, several problems with existing transmission pricing mechanisms have been identified. I'm told that: current transmission pricing mechanisms that are based on embedded costs may not accurately reflect the costs of transmission services through several utility systems; line losses are not priced accurately; current pricing methods are not well designed for non-firm transmission services; and current pricing methods do not encourage the proper expansion of the transmission grid.

In the RTO NOPR, the Commission addressed several areas where it will consider transmission pricing reform. First, we announced that we will continue to allow "license plate" pricing instead of requiring a single transmission access rate. Some see this as necessary to avoid flash cut cost shifting among the transmission owners joining an RTO. License plate prices are access fees paid by load serving entities based on the fixed

transmission costs of the local utility. We indicated that this would be a transitional remedy and that we would be considering appropriate long-term measures.

The Commission next proposed to allow RTOs considerable flexibility in experimenting with different market approaches to managing congestion through pricing. I believe this flexible approach is appropriate given the regional differences in the way that transmission and generation systems have been built and are operated in this country. These distinct regional transmission characteristics and circumstances require regional solutions. As we indicate in the NOPR, there is no “one-size-fits-all” solution to the problem of transmission pricing. However, we do state that all RTO proposals should ensure that: generators dispatched in the presence of transmission constraints are those that can serve system loads at least cost; and limited transmission capacity is used by market participants who value its use most highly.

Once RTOs are formed, the Commission proposes as part of its transmission pricing reforms to consider performance-based regulation (PBR) to ensure their satisfactory performance. We indicate that these PBRs may comprise price or revenue caps, price incentives or performance standards. Performance-based regulation would identify factors of good performance such as efficient congestion management, lowering operator costs, and meeting reliability targets.

In the NOPR, the Commission also signaled a willingness to consider offering incentives on a case-by-case basis in order to encourage transmission owners to turn over control of their facilities to an RTO. We stressed that RTOs would bring extensive benefits to North American electricity markets and that we would consider allowing transmission owners that bring about these benefits to share in them through incentive pricing. We specifically mention several types of incentives, including: allowing RTO participants to receive a higher return on equity (ROE) than under current policy; keeping transmission rates level and allowing transmission owners to benefit from cost savings; allowing participants accelerated cost recovery for costs of transmission

expansion; accepting a higher valuation of transmission assets using non-traditional methods, such as replacement cost, and allowing the RTO to include in its rates an acquisition premium that reflects the enhanced value.

It should be clear from the RTO NOPR that the Commission is serious about reforming the manner in which transmission services are priced. I am committed to making this an important aspect of our regional transmission policies.

### **Transmission Expansion**

The last of the three topics I'll discuss today is perhaps the most difficult. That topic is transmission expansion. Or more specifically, how to provide the proper incentives to investors and market participants to expand and enhance the transmission grid. Through meetings, conferences, and case filings, I've received fairly strong and consistent messages from the industry that the Commission needs to be more mindful of financial realities so that a transmission business will be able to attract the necessary capital and financing. I understand that some in the industry believe there are inadequate incentives for new transmission investment and that the lack of investment in new transmission facilities is related to insufficient returns on equity on transmission assets. These industry participants also contend that if the Commission persists in allowing lower ROEs, not only will there be insufficient investment, but it will also discourage utilities from putting their transmission assets into an RTO. For obvious reasons, I am concerned about these observations.

In today's electricity markets, demand is growing at a significant rate and merchant generating plants, along with other types of generation, are being built at unprecedented levels. However, the transmission grid is nearly static. The reason most often given is the expectation that the transmission investor will suffer. Another important reason is that there would likely be difficulties with siting new facilities at the state level. Obviously, the Commission can not do much on the state siting issue, but we can do something about encouraging sufficient transmission investment.



What must FERC do to ensure that sufficient investment is made to expand and upgrade the grid and to encourage the development and use of new technologies to enhance its efficiency? I think part of the answer lies in pricing and planning reforms that provide proper incentives for transmission expansion, including the Commission's ROE policies. Another part of the equation is in regional approaches to determining the need, something our NOPR addresses. This is an issue that will require a significant amount of attention by the Commission. The industry, the financial community, and others are closely watching actions by the Commission with regards to establishing transmission rates of return.

I believe the Commission must carefully consider the profound changes currently taking place in the industry, such as retail and wholesale restructuring, major realignments and mergers, and the formation of RTOs, in order to determine the extent to which these factors should be incorporated into future ROE determinations. The Commission must determine how these new market uncertainties are equating into risk for transmission businesses. Are these factors increasing risk or is risk static or in some cases lower? How must the Commission's ROE policies be adjusted to account for changes in risk?

First and foremost, the Commission must endeavor to ensure that transmission owners, operators and investors are not disadvantaged as a result of the fundamental changes occurring in the electric industry. We must ensure that our ROE policies and practices encourage and facilitate the attraction of capital needed for appropriate and sufficient investment in transmission expansion. I believe that such transmission investment is a vital requirement for the ultimate success of the Commission's goals of open, non-discriminatory transmission access and competitive wholesale electricity markets.

In closing, let me say that the Commission still has a lot to learn about efficient regional transmission congestion mechanisms, transmission pricing reforms, and the

proper incentives necessary to induce sufficient transmission investment. However, I'm confident that, with the continued help of the industry, the Commission will accomplish these objectives so that the Nation's transmission grid will compliment, and not impede, the development of a robust and vibrant competitive marketplace.

Thank you very much.